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SUBJECT: UPDATE ON NEW ZEALND'S MONETARY AND FISCAL POSITION AS THE
GOVERNMENT PREPARES FOR ANNUAL BUDGET

WELLINGTON 00000108 001.2 OF 003

¶1. (U) Summary. On April 30, the Reserve Bank of New Zealand (RBNZ) reduced the Official Cash Rate (OCR) by 50 basis points to 2.5 percent. The RBNZ move continues a series of dramatic cuts since July 2008 when the OCR stood at 8.25 percent. Economists reacted favorably to both the size of the cut and the RBNZ Governor hint of possible future cuts. Meanwhile GNZ fiscal policy came under closer scrutiny in a recent OECD country survey with broad implications for the pending annual budget priorities. Finance Minister Bill English continues to dampen public expectations in the lead-up to the May 28 budget by outlining his concerns about the economic storm hitting New Zealand and possibly scrapping planned future tax cuts. End Summary.

Monetary Policy Update

¶2. (U) On April 30, the Reserve Bank of New Zealand (RBNZ) reduced the Official Cash Rate (OCR) by 50 basis points to 2.5 percent. In making the announcement RBNZ Governor Alan Bollard said, "overall, developments since March (2009) point to lower medium-term inflation than previously projected - the main factors behind this are weaker global growth, and an unwarranted tightening in financial conditions via both higher long-term interest rates and a stronger exchange rate than expected."

¶3. (U) The RBNZ move continues a series of dramatic cuts since July 2008 when the OCR stood at 8.25 percent, taking the OCR to its lowest level since it was created in 1999. Significantly, Bollard indicated there may yet be more OCR cuts. "We consider it appropriate to provide further (monetary) policy stimulus to the economy - We expect to keep the OCR at or below the current level through until the latter part of 2010." "The OCR could still move modestly lower over the coming quarters," said Bollard.

¶4. (U) In announcing the move, Bollard, as he has with previous rate cuts, gave the commercial banks a public nudge suggesting their rates could be lowered further. The commercial banks have been complaining about the high cost of borrowing from overseas - which makes up about 40 percent of their funding - as the root cause of the lack of significant discounting in the commercial interest rates. In reaction to previous lowering of the OCR, the rates the commercial banks charge each other for funds rose, as did the New Zealand dollar since the last RBNZ intervention. Long-term mortgage

rates also rose as thousands of customers clamored to fix rates, thinking they might miss out on any possible future bargains.

¶5. (U) Westpac is the only commercial bank so far to announce that it will lower its six-month fixed mortgage rate to 5.39 percent from 5.79 percent following the OCR drop. Of the six major commercial banks currently operating in the NZ market (ANZ, ASB, BNZ, National, Kiwi and Westpac) the rates for commercial loans range from a low of 5.39 to a high of 7.60 percent. The New Zealand dollar (NZD) immediately dropped about three-quarters of a cent against the U.S. dollar (USD) following the announcement and was trading around the US56 cent range.

¶6. (U) Economists generally reacted favorably to both the size of the cut and the accompanying statement from the RBNZ Governor. The latest National Bank business outlook survey released April 29 recorded the biggest improvement in sentiment among Kiwi companies since the December 2000 survey. "A turning point appears to have been reached for the economy," National Bank chief economist Cameron Bagrie said.

¶7. (U) The currency market reaction to the last OCR reduction in March seemed counter-intuitive and caused the Kiwi dollar to rise to the annoyance of exporters. The RBNZ Governor's statement seemed to signal that any future cuts were "not likely to see the near-zero interest rates of other countries" which led currency speculation to assume they had reached bottom, which then lead to the Kiwi dollar's rise. With the latest announcement by RBNZ and the possibility of future reductions in the OCR, pressure on the Kiwi dollar is likely to subside with improved prospects for exporters.

OECD Biennial Report - Impact on Fiscal Policy
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¶8. (U) The Organization for Economic Co-operation and Development's

(OECD) biennial report on New Zealand's economy (released April 16) highlighted several dilemmas facing the Government as it finalizes the annual budget to be announced on May 28. First, the OECD warns that the recession in New Zealand will be deep and protracted. Moreover, it sees little room for further fiscal stimulus and looks instead to the RBNZ to deliver more relief.

The OECD Report's major recommendations:

-- Raising the age of eligibility for NZ Superannuation and de-linking it from the average wage.

-- Lowering company tax and the top income tax rate but raising GST.

-- Privatizing Air New Zealand, KiwiRail, KiwiBank, Solid Energy and the three state-owned electricity generators.

-- Overhauling funder/provider relationships in the health sector.

-- Making more use of the toll roads and congestion charging.

¶9. (U) The OECD report highlights a trio of problems facing the Government budget planners. Two are of long standing, one is new. First is the ageing of the population, with its implications for higher health and superannuation (social security) costs in the future. Both pension and health spending are expected to grow faster in New Zealand than in the OECD as a whole, it says, taking up an additional 8.2 per cent of GDP by the middle of the century. Second is the underlying underperformance of the economy in terms of productivity. Some of that, the OECD concedes, may be put down to being small and remote, but some of it might be improved by better policy. The third, and new, factor is the recession. The OECD forecasts that over the course of 2008, 2009 and 2010 the economy will shrink a cumulative 2 percent but inflation should remain low.

¶10. (U) The tax base by the end of next year will be significantly smaller than might have been expected, by tens of billions of dollars, leaving the Government with a permanent downward shift in

the revenue track. In addition, steeply rising debt, as deficits replace the fiscal surpluses of the past 14 years, will add to the taxpayer's burden. Per the OECD, this leaves the Government with a delicate balancing act - it has to ensure fiscal policy is not a drag on the economy, which would be self-defeating. The OECD report warned, "it is vital that next month's budget presents a credible medium-term program that will re-establish a structural surplus, and a surplus large enough to cope with the pressures of an ageing population - failing that, the Government would need to begin to scale back future health and pension spending."

Critique of OECD Recommendation

¶11. (U) Opposition Labour Leader Phil Goff said the OECD's forecast that the economy would remain in recession through the rest of the year was at odds with Prime Minister John Key's view of an aggressive recovery beginning late this year or early next year. "Two-thirds of the fiscal stimulus which had taken place already was in Labour's budget last year," said Goff. He noted the OECD's observation that tax cuts tend to be less effective than increased Government spending ("if judiciously chosen") as a boost to demand. "The tax cuts at the start of April 2009 were especially impotent as they were targeted at those on higher incomes who would be more inclined to save them than spend them," according to Goff. He expects the Government will not go ahead with the tax cuts promised for 2010 and 2011 which Goff believes wil leave most New Zealanders worse off than they would have been under Labour's package. Goff also rejects the OECD's call to sell state assets.

¶12. (U) The Council of Trade Unions (CTU) economist Peter Conway said the report contained some good suggestions but it largely missed the point. "Although there are some good suggestions made, overall the prescription is to privatize in electricity, ports, ACC (publicly funded accident and disability insurance) and health despite the fact that we have just witnessed massive private sector failure in financial management which has required huge bailouts by the public sector." The CTU says the OECD's other proposals such as lifting the retirement age and breaking up national wage bargaining

in the health sector also raise major concerns.

Expectations for May 28 Budget

¶13. (U) Internalizing some of the OECD recommendations, Finance Minister Bill English continues to dampen public expectations in the lead-up to the May 28 budget. English recently outlined his concerns about the economic storm hitting New Zealand and began to put forward a case to scrap planned future tax cuts. "Because of the difficult economic and fiscal circumstances we face over the next few years, we've signaled that we are considering the future of income tax cuts planned for 2010 and 2011, as well as the Government's contributions to the New Zealand Superannuation Fund." In a recent speech to businessmen in Christchurch, Mr. English repeated much of the dark economic statistics he faces in writing his first budget. The budget will focus on reprioritizing government spending, particularly spending for public services. There will be no room for significant fiscal stimulus in the budget and the rate of increased spending will be lower than in the past. He said New Zealand is expected to permanently lose about NZ$50 billion of output over the three years to 2012 because of the recession. Tax revenue and receipts for the eight months to February are NZ$1.8 billion lower than forecast in the pre-election update.

¶14. (U) English said his budget would set ways to preserve entitlements at current levels -- such as superannuation payments -- and stop debt levels blowing out to 45 percent of GDP by 2013. (Note: NZ ranks 29 out of 31 OECD monitored countries -- includes Euro area as composite -- in its percentage of debt to GDP just ahead of Hungary and Iceland; the U.S. is 16. End Note.) The superannuation fund had been set up when the Government's accounts were expected to stay in surplus for the foreseeable future. "The Government will have to borrow quite a lot of money to make its full

superannuation fund contributions. Next year we would have to borrow around NZ$2 billion, or around NZ$40 million a week to put into the fund, to be invested in what are currently uncertain global financial markets."

¶15. (SBU) Comment: Despite the National Party's campaign promise to deliver on future tax cuts, it seems prepared to accept some of the OECD recommendations and face the storm of criticism from political opponents rather than exacerbate the country's debt load by turning to international financing to maintain current fiscal levels. The National led government has been emboldened by recent polling indicating that fifty-two percent of voters favor this approach. Meanwhile, privatization of state owned assets is likely to remain on hold, at least in the near-term, but attempts to run those enterprises along private sector principles will be expected.

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